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February 6, 1985

To: Members of the Executive Board

From: The Secretary

Subject: United Kingdom - Staff Report for the 1984 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1984 Article IV consultation with the United Kingdom, which has been tentatively scheduled for discussion on Wednesday, March 6, 1985.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Schmitt, ext. 572933.

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INTERNATIONAL MONETARY FUND

UNITED KINGDOM

Staff Report for the 1984 Article IV Consultation

Prepared by the Staff Representatives for the 1984 Consultation with the United Kingdom

Approved by Brian Rose and J. T. Boorman

February 6, 1985

I. Introduction

A staff team, consisting of Messrs. Schmitt, Vittas, Horiguchi, Ms. Salop, Mr. Kashiwagi, and Ms. Daniels as secretary (all EUR), held Article IV consultation discussions in London from November 30 to December 10, 1984. The U.K. representatives included officials of the Treasury, the Central Statistical Office, the Departments of Energy, of Trade and Industry, and of Employment, and the Bank of England. Messrs. Schmitt and Vittas also met the Chancellor of the Exchequer, Mr. Nigel Lawson, and the Permanent Secretary of the Treasury, Sir Peter Middleton. Mr. Nigel Wicks, Executive Director for the United Kingdom, attended the meetings as an observer. The United Kingdom formally accepted the obligations of Article VIII, Sections 2, 3, and 4, as of February 15, 1961.

II. The Economic Background

Over the past several years, the U.K. authorities have had considerable success in implementing their medium-term financial strategy. The rate of monetary expansion has been brought under control and public sector borrowing, as a ratio to GDP, has been reduced markedly. As a result, the growth in nominal GDP has been lowered progressively from over 15 percent in 1979-80 to less than 7 percent in the first three quarters of 1984, and the split between inflation and output gains has become more satisfactory in recent years (Chart 1). By contrast, the Government's efforts at restoring a better balance in industrial relations and increasing the flexibility of the labor market have not yet had any clear effect on real wage trends. To be sure, the rate of return on capital in the non-oil sector has risen markedly, from a very low base, since 1981. However, this has been associated in large part with exceptional productivity gains resulting from a major shake-out of labor, as well as a decline in the real price of material inputs and taxes on employment. Real wage earnings, especially in manufacturing, have continued to rise more rapidly than would be warranted by the underlying growth in productivity and shifts in the external terms of trade.

The recovery of activity, which had started much earlier than in the other major industrial countries, gathered some strength in 1983 when real GDP increased by 3 1/4 percent. In the first three quarters of 1984, however, output growth slackened to a year-on-year rate of about 2 percent, partly under the impact of the prolonged coal miners' dispute. The upturn has so far proceeded at much the same pace as in earlier cycles. Nevertheless, real GDP in the third quarter of 1984 was only 4 percent higher than at its previous peak more than five years earlier, reflecting the severity of the intervening recession. The picture in manufacturing is worse. Output in that sector has shown some revival only since late 1982 and is still about 10 percent lower than five years ago. Total employment (including the self-employed) has been rising at an annual rate of three quarters of 1 percent since early 1983, with the increase concentrated on part-time jobs for female workers in the services industries. However, the growth of the labor force has accelerated, reflecting demographic developments and, more importantly, a resumption of the upward trend of female participation rates. Thus, except for a brief interruption during 1983, the adult unemployment rate has continued to increase, reaching about 13 percent by the end of 1984 (Chart 2). Over the last five years, unemployment has nearly trebled to 3.1 million and the proportion of those unemployed for more than a year has risen to nearly 40 percent from 24 percent of the total in 1979.

While the growth of output has slackened, the pattern of demand has recently improved. In 1983 consumer spending rose strongly, owing in part to a decline in the savings ratio, but residential construction and government spending were also buoyant. The contribution of net exports was negative to the tune of 1 percent of GDP, and business fixed investment was weak. In the first three quarters of 1984, the worsening of the net foreign balance was small, as export growth accelerated, and there was a strong upturn in business investment, but all the other components of domestic demand weakened. The upturn in capital spending was most pronounced in the manufacturing sector and came in the wake of a marked improvement in the financial position of the company sector and in the real rate of return on capital. The latter is estimated to have increased from a low of 3 1/2 percent in 1981 to about 7 percent in the first half of 1984, excluding North Sea oil operations.

In nominal terms, the rate of increase in average wage earnings in the whole economy has come down from more than 20 percent in 1980 to about 8 percent by end-1983 (Chart 3). However, as inflation has also been reduced, real earnings have continued to grow, by about 1 percent per annum in 1981-82 and no less than 3 1/2 percent in 1983. Actual earnings during 1984 have been depressed by the coal miners' dispute and by delays in other settlements, but the underlying trend seems if anything to have accelerated. In manufacturing, wage inflation has generally been higher than in other sectors, and unit labor costs have been contained only through labor shedding, which has allowed productivity to rise at an annual rate of 5 percent in 1981-83. However, during the first nine months of 1984, productivity growth slowed markedly and the rise in unit wage costs accelerated from 2 percent in 1983 to an annual rate of more than 5 percent. Although this rate was much higher than in the United

Kingdom's main trading partner countries, cost competitiveness has not deteriorated as the effective exchange rate of sterling has fallen. By the third quarter of 1984 the real effective exchange rate, as measured by relative normalized unit labor costs adjusted for exchange rate changes, was about 18 percent below its peak in early 1981 but still some 28 percent higher than in 1978 (Chart 4).

Despite the strength of the recovery in 1983, the rate of inflation (CPI) continued to decelerate and, at 4.6 percent, it was at its lowest level in 16 years. Since late 1983, inflation has fluctuated narrowly around 5 percent with no clear upward trend, as the weakness in oil and other commodity prices has helped offset the effects of the fall in the exchange rate and the recent escalation in unit wage costs. Profit margins are likely to have narrowed somewhat, following a strong improvement in 1981-83.

The current account of the balance of payments has been in surplus since 1980 when the United Kingdom emerged as a net exporter of oil. However, the surplus peaked at 2 1/2 percent of GDP in 1981 and has since declined steadily to practically zero in 1984, notwithstanding the growth in net oil exports to some 2 1/4 percent of GDP. In particular, for the first time in recent history, the balance of trade in manufactures turned negative in 1983, with the United Kingdom continuing to experience losses in market shares both at home and abroad. These losses, which reflected the serious erosion of the competitive position of the United Kingdom in 1978-81, appear to have become smaller recently, as competitiveness has recovered. The current surplus has generally been matched by a net capital outflow, much of it in the form of purchases of foreign securities by U.K. financial intermediaries following the dismantling of exchange controls in 1979.

The nominal effective exchange rate index of sterling fell by some 10 1/2 percent during 1984, bringing its cumulative decline since early 1981 to 28 percent (Chart 5). Although much of this fall was the counterpart of the strengthening of the U.S. dollar, sterling also weakened markedly during 1984 against most of the other major currencies. External reserves (IFS basis) fell by about SDR 1.5 billion during 1984 and by a total of some SDR 7 billion since 1980, owing in part to repayments of official external debt. By September 1984, this debt was down to SDR 8 billion, or equivalent to about 2 1/2 percent of GDP.

III. The Policy Discussions

With price inflation down and unemployment rising to record levels the policy debate in the United Kingdom has focused increasingly on the unemployment issue. At one extreme, unemployment is attributed to a deficiency in aggregate demand resulting from restrictive financial policies, with the implication that such policies should be eased. At the other extreme, unemployment is attributed to real wage rigidity, with the implication that it can only be tackled through reforms that will allow labor to price itself back into the market.

The authorities have stated repeatedly that they have no intention of changing their economic strategy. There is nevertheless a perception, particularly in financial markets, that priorities may have shifted within the framework of that strategy from lowering inflation to lowering unemployment. This perception is based in part on an apparent easing of fiscal policy since late 1982, and more recently on a reluctance to see interest rates rise despite significant declines in the exchange value of sterling.

Against this background, the discussions centered on the question whether financial policies were still sufficiently restrained to allow for a consolidation, and then an extension, of the progress that has been achieved in reducing inflation. The role of the exchange rate was examined, both for its effect on prices and for its potential impact on competitiveness. In this context the discussions probed the determinants of wages and the scope for measures to improve the functioning of labor markets.

1. General economic strategy

The present Government's economic strategy is characterized by the simultaneous pursuit of firm macroeconomic policies directed at curbing inflation, and of microeconomic policies geared to improving the supply side of the economy so as to promote the growth of output and employment. The U.K. representatives said that, seen in this light, the question whether the policy emphasis had, or ought to have, shifted from lowering inflation to lowering unemployment was misguided. The Government's strategy had aimed, and would continue to aim, at both lower inflation and a sustained growth of output and employment. Between policies to pursue these two aims, there could be no conflict.

Macroeconomic policy has been guided by the medium-term financial strategy (MTFS) which was first introduced in the Budget for 1980/81. The MTFS consisted of two principal elements: a progressive slowing in the pace of monetary expansion designed to bring inflation down and a substantial scaling down over time in the public sector borrowing requirement (PSBR), to ensure that monetary deceleration would not result in excessively high interest rates. The scaling down of the PSBR was to be sought mainly by a reduction in public spending in relation to GDP.

By casting monetary and fiscal policies in a medium-term context, rather than in the context of short-term demand management, the MTFS was to underscore the resolve of the authorities to maintain persistent downward pressure on the growth of nominal demand and inflation over an extended period of time. Given the entrenchment of inflationary expectations, the Government judged it essential that it set out clearly and for some years ahead the financial framework that it would pursue, thereby sending a clear signal about the extent of the adjustment required.

2. Monetary policy

The policy of progressively scaling down rates of monetary growth in order to put downward pressure on price inflation was rolled forward in the Budget for 1984/85. The target range for the growth of the broad aggregate £M3 was lowered to 6-10 percent from 7-11 percent in the previous financial year; a separate range of 4-8 percent was set for the monetary base Mo, while targeting of M1 and PSL2 was abandoned. Illustrative ranges for the subsequent four years had the growth targets for £M3 and Mo declining progressively to 2-6 percent and 0-4 percent, respectively. Equal weight would be given to the broad and to the narrow monetary aggregate in the assessment of monetary conditions. In the face of uncertainty about the behavior of the targeted monetary aggregates at a time of rapid financial innovation, the authorities would also continue to take into account other relevant indicators, including interest and exchange rate developments.

From the early part of the current financial year, £M3 had shown a tendency to overshoot its target range and, after staying at the upper end of the range for three consecutive months, it did so again in the banking month of November. Monetary base (Mo) continued to grow at about the middle of its target range. Though other monetary aggregates grew consistently faster than the two targeted aggregates, the U.K. representatives judged that the movements of the targeted monetary aggregates indicated generally satisfactory monetary conditions. They noted that the overshooting of £M3 was largely attributable early in the year to the front-loading of the PSBR, and more recently to the buildup of cash balances by the public in preparation for the purchase of shares in British Telecom, which was being privatized.

The staff team ventured that monetary expansion, while conforming broadly with the targets set, might nevertheless have been too rapid to maintain persistent downward pressure on inflation. The targets might have been set too generously in the first place; for example, the target for £M3 did not seem to have allowed for the rapid growth in building society deposits, which in part may have substituted for bank deposits in the financial holdings of the public. Moreover, as the expansion of bank credit to the private sector remained buoyant, the authorities were only able to keep the growth of £M3 within the target range by increasing sales of government debt to the public, in amounts that occasionally exceeded the borrowing requirement, while relieving the consequent cash shortage in the money market through purchases of bills (see Table 1 and Appendix IV in the recent economic developments paper). To judge the degree of monetary stringency in these circumstances, more than usual reliance would have to be placed on the supplementary indicators. The very rapid rise in the nontargeted monetary aggregates such as M2 and PSL2 (Chart 6) was worrisome in this connection. So was the steep depreciation of sterling in the exchange market in the course of the year.

The U.K. representatives did not agree that monetary policy might have to be tightened to keep inflation in check. They acknowledged that there had not been much progress on the inflation front recently, and the progress expected in the period ahead, even assuming no further depreciation of the pound, was rather slow and modest. However, they did not see the target paths of £M3 and Mo, tentatively set for the next few years in the latest MTFS, as endangering inflation performance in any fundamental sense. They noted that inflation only needed to come down, on average, by half a percentage point a year for price stability to be reached in the period to 1993/94, as projected by the authorities. Of course, it was possible for the rate of inflation to fluctuate around that intended path from year to year; monetary policy was not to react to such short-term movements but to exert persistent downward pressure on inflation over an extended period of time.

The U.K. representatives emphasized that it was the targeted monetary aggregates, rather than the exchange rate or other supplementary indicators, that were of central relevance in judging monetary conditions. The authorities took the exchange rate into account when there was reason to believe that the targeted monetary aggregates were giving a false reading. At this juncture, the U.K. representatives saw no compelling reason to believe that this was the case. They cautioned against reading too much into the monetary aggregates which were not targeted, such as PSL2 and M2, in assessing the stance of policy. The behavior of these aggregates was complicated by the financial innovations that had been taking place since 1979. These innovations had led to equivalent increases in the gross debt and financial assets of the personal sector, notably in building society deposits which were included in both PSL2 and M2 but not in £M3.

3. Exchange rate policies

The U.K. representatives stressed again the incompatibility of exchange rate targeting with a strategy based on targeting the monetary aggregates. Accordingly, no target had been set for the exchange rate; it was left instead to be determined by market forces. Exchange market intervention was generally restricted to occasions when there was a threat of disorderly conditions there. It was nevertheless understood that a monetary policy which would exert steady downward pressure on price movements would, in a given world environment, exert steady upward pressure on movements in the exchange rate also. Exchange rates could therefore give some evidence of the tightness or ease in money markets, and for this reason continued to play a significant role as a supplementary indicator for monetary policy.

In the view of the U.K. representatives, if the monetary aggregates were kept under firm control, U.K. nominal interest rates would not have to follow foreign rates, even though the resulting change in interest rate differentials would lead to exchange rate changes. Exchange rate movements in response to transitory outside developments would tend to correct themselves relatively quickly without any lasting inflationary impact. The U.K. representatives described the decline in the effective value of sterling over the past year as largely due to the strength of the dollar, which they judged to be temporary. Of course, it would be very difficult for the authorities to stand aside when exchange markets were disorderly because of doubts about the soundness of monetary policy. In such instances, the authorities might choose to take steps, as they did in July 1984, to tighten monetary conditions beyond what might be called for by underlying developments, as a means to reassure the markets.

If, on the other hand, exchange rate depreciation was judged to be caused by a permanent nonmonetary development, the authorities would have to take it into account, even when domestic monetary conditions were otherwise judged to have been sound. Downward pressure on the exchange rate would very likely increase, for example, when oil production begins to decline or when oil prices fall. The extent to which monetary restraint would be intensified in such circumstances would reflect the firmness of the authorities' commitment to price stability. The real exchange rate would have to decline if external balance was to be maintained at present levels of activity. However, the ability of the authorities to influence the real exchange rate through the nominal rate appeared to be very slight.

It was noted that, at its present level, the real exchange rate of the pound was already inconsistent with external equilibrium at full employment. The U.K. representatives drew a sharp distinction between the effects of a change in the real exchange rate that might emerge from a depreciation of the nominal rate and those resulting from an improvement in domestic cost conditions relative to those abroad. In the first instance, higher prices resulting from currency depreciation would have to be accommodated by monetary expansion, if the level of activity and of employment was to expand rather than to shrink. The scope for that was clearly limited, given the declared strategy of bringing inflation down. In the latter case, real activity would benefit even with the present restraints on monetary expansion, as the real quantity of money would be more ample with prices lower than they would otherwise have been.

The staff team wondered whether, given the likely pressures on the exchange rate, participation in the exchange rate arrangements of the European Monetary System (EMS) might not have become more attractive. The U.K. representatives replied that, although this matter was kept under continuous review, there were no immediate plans to join the arrangements. The principal reservations revolved around sterling's status as a petro-currency and the uncertain prospects for petroleum prices; around the unpredictability of the movements in the U.S. dollar which would differ in their effects on the member currencies of the EMS; and not least, around the potential incompatibility of exchange rate targeting with the policy of targeting the monetary aggregates with which the authorities had been broadly satisfied.

4. Fiscal policy

Fiscal policy within the medium-term strategy was directed at a progressive scaling down of the public sector borrowing requirement (PSBR) relative to GDP so that monetary restraint would not place undue pressure on interest rates. Illustrative projections in a Green Paper published with the 1984/85 Budget envisaged that by 1993/94 the PSBR as a ratio to GDP would be down to 1 percent. With the inflation rate assumed to have come down to zero by that time, and the long-term growth of output to have stabilized at an annual 2 percent, such a PSBR would keep the ratio of the public debt to GDP steady at about its present level of 45 percent. A similar growth of private debt would support a structure of interest rates consistent with the projected growth of output. In setting the path of the PSBR in the transition to that goal, the ratio of public debt to money GDP was assumed to remain broadly constant, after allowing for the effects of asset sales and North Sea revenues.

When formulating its medium-term strategy, the Government had intended to reduce public spending in relation to GDP so as to scale back the burden of Government on the economy. The U.K. representatives acknowledged that actual developments had been disappointing in this regard. Although successive versions of the MTFS had envisaged substantial reductions in public sector spending in relation to GDP, in practice it has not proved possible to achieve these. The ratio of general government expenditure alone to GDP actually rose from just over 42 percent in 1979/80 to about 46 percent in 1983/84, and according to the latest estimates, should remain broadly the same in 1984/85. Accordingly, the Government was taking further measures to strengthen expenditure control. In particular, current expenditure by the local authorities, which had been a major contributor to spending overruns, was to be restrained by rate capping and by severe cuts in grants to penalize overspending.

The ratio of the PSBR to GDP was nevertheless brought down, from its 1980/81 peak of 5 1/4 percent to 3 percent in 1982/83, through revenue increases notably including oil revenues (Chart 7). However, although budgeted to decline by another 1/2 percentage point in 1983/84, the PSBR had then remained constant. The 1984/85 Budget was to bring the PSBR down to 2 1/4 percent, back to the path envisaged for it in the MTFS. Public expenditure was projected to remain constant in real terms and to decline substantially in relation to GDP. Revenues were to be buoyed by a continued recovery in activity and by advancing payments of VAT on imports. However, the outturn for the first eight months of the financial year caused the Chancellor in his Autumn Statement to raise the projected PSBR to 2 1/2 percent of GDP, despite higher oil revenues resulting from the depreciation of the pound. The increase reflected the effects of the coal miners' strike, as well as expenditure overruns by local authorities and unexpectedly high public sector pay settlements.

Staff calculations suggested that the budget outturn in 1982/83 and 1983/84 provided a stimulus to economic activity in excess of 1 percent of GDP each year, following a cumulative withdrawal of stimulus in excess of 3 percent of GDP in the two years to 1981/82. In its original version, the 1984/85 Budget was to have followed with a net withdrawal equivalent to some 1/2 percent of GDP, but the prospective outturn is now very much in doubt. The U.K. representatives downplayed the significance of the surprisingly stimulatory fiscal outturns in the past two years, reiterating the medium-term orientation of their strategy. They recalled that measures had been taken to curb government spending after mid-1983 in order to minimize any overshooting of the 1983/84 PSBR, and noted that part of the expenditure overrun in 1984/85 was due to the miners' strike. Furthermore, even at 2 1/2 percent of GDP, the PSBR would be smaller in relation to GDP than at any time in more than a decade.

The U.K. representatives were conscious that, although the PSBR as measured was to resume its downward trend, its "quality" had deteriorated in the sense that, to bring it down, increasing reliance was being placed on transitory factors such as asset sales and oil revenues (Table 2). Special sales of public sector assets had increased significantly in recent years and were projected to remain high in 1985/86. Tax receipts from North Sea oil production were expected to peak in 1985/86 at a level not much above that reached in 1984/85, and then to decline. There was, to be sure, a permanent element in oil revenue which, although not large, had to be taken into account. Adjusted for all these factors, the PSBR turned out not to have declined at all in relation to GDP, but rather to have increased from 4 3/4 percent in 1981/82 to an estimated 6 1/4 percent in 1984/85, leaving a rather large adjustment yet to be made to reach the 1 percent envisaged for 1993/94.

The U.K. representatives acknowledged that, although asset sales, and oil revenues inflated by the depreciation of sterling in 1984/85, reduced the PSBR, neither of these had had a major restraining impact on domestic demand or on monetary conditions. They suggested, however, that any adverse effect such a shift in the composition of the PSBR might have had on real interest rates would be small in a situation of international capital mobility where domestic real interest rates largely reflected those set in international markets dominated by the United States. While allowing that the urgency of reducing the PSBR had thus diminished, the U.K. representatives cautioned that this line of argument should not be taken too far because, as evidenced by the lower real long-term interest rates in the United Kingdom than in the United States, there remained at least some scope for decoupling. Reduction in the PSBR thus remained an important element in the medium-term strategy.

New fiscal projections for 1985/86 in the Chancellor's Autumn Statement showed both income and expenditure higher than had been envisaged at the time of the last budget, but the targeted PSBR at 2 percent of GDP remained the same as indicated earlier. Projected expenditure would be even higher had not the planned sales of assets, which are counted as negative expenditure, been revised upward by £1/2 billion, and had not the contingency reserve, which is included in total expenditure, been lowered by £3/4 billion. The upward revision of revenues in 1985/86 takes account again of the increase in oil revenues resulting from the depreciation of the pound in the course of 1984. The PSBR that results from these projections falls short of its targeted value by some £1 1/2 billion, leaving room for a fiscal adjustment of that amount, which could be used to reduce taxes in 1985/86.

Tax relief was judged to have been long overdue as a means to improve the supply side of the economy by strengthening incentives. The room for further fiscal adjustments was projected to expand for some years ahead. In the version of the MTFS issued with the 1984/85 Budget, the PSBR was to decline to 1 3/4 percent of GDP by 1988/89. On the basis of policies then in place, the ratio of public sector revenue to GDP would decline by only 1/2 percentage point over its five-year horizon, whereas public spending, assuming it was held constant in real terms, would decline by 4 percentage points in relation to GDP. The sum of revenue and the targeted PSBR would exceed spending by 1/2 percent of GDP in 1985/86 and a cumulative 3 1/4 percent of GDP by 1988/89, leaving a substantial margin for discretionary measures which would preferably take the form of additional cuts in general taxation. Such tax relief would not necessarily be aimed at stimulating demand; it would in any case be contingent on the achievement of the projected expenditure restraint.

The U.K. representatives acknowledged that the targeted pace of reductions in the PSBR would require more significant adjustments in the longer run when reliance on asset sales and oil revenues would have to diminish. They argued, however, that a more rapid reduction in the PSBR could not be justified during a period when the PSBR was already at a level lower than would stabilize the ratio of the public debt to GDP at the current growth of nominal incomes. They thought it right, instead, to grasp the opportunity to introduce reforms aimed at creating a simpler and more efficient tax system in the context of general tax relief. A reform of company taxation had already been initiated with the 1984/85 Budget to reduce distortions affecting the choice between different assets and between different methods of raising funds. Further reforms would probably concentrate on personal taxation to improve incentives to work.

5. Labor market policies

In formulating their economic strategy the Government had deliberately chosen not to set targets in terms of ultimate output and employment objectives, on the grounds that these were not within their direct control. The split of nominal income between prices and output, and consequently developments in employment, were left to be determined by the market. It was expected that an anti-inflationary financial policy would almost inevitably impose some initial loss of output and employment, with the size and duration of these initial effects determined in large measure by how quickly wage behavior would respond to the new environment. The deceleration of nominal wages has in fact continued to lag behind the reduction in price inflation. Real wages have thus risen persistently, and unemployment has surged to an overall rate of 13 percent, with the number of those unemployed for more than a year rising to 5 percent.

The staff team asked whether delayed adjustments of price expectations to the actual decline in price inflation could account for the buoyancy of real wages (Table 3 and Chart 8). Wage contracts apparently set nominal wages to produce real wages that with given price expectations would maintain employment. If actual inflation then turned out to be higher than expected, real wages would turn out lower, and employment rise higher than was expected at the time the bargain was struck. However, if actual inflation turned out to be lower, real wages would be higher than expected, and employment would drop as firms shed more labor in response. It was noted that, to bring expected and actual inflation close together, a pause in the deceleration of actual inflation was sometimes proposed. On the other hand, such a pause could place in doubt the resolve of the authorities to bring inflation down. If price expectations were to stabilize at all, therefore, it would continue to be important to persist with the strategy as it stood.

The scope for fiscal expansion, although widely urged as a means to raise output and employment, was also judged to be limited. To be sure, a given stimulus, whether through increased expenditure on public works or a reduction in taxes, would have a relatively small effect on real interest rates in the United Kingdom, and therefore a relatively large effect on aggregate demand. Also, while the increased demand for real money balances would not, in a regime of floating exchange rates, be satisfied by capital inflows, it would with given nominal money supply targets be met by the downward pressure on prices of an appreciating exchange rate. However, the resulting loss of competitiveness would in due course bring about a deterioration in the external balance to moderate the fiscal stimulus. A larger PSBR would also delay the time when the growth of public debt could be brought into line with noninflationary growth.

A steady pursuit of anti-inflationary financial policies should, once the convergence of expected and actual inflation was achieved, hold down increases in real wages. However, in order to reduce real wages to the level warranted by productivity, the functioning of labor markets had to be improved, so as to allow the unemployed to become a factor in the wage bargain. The Government had taken a variety of measures in the past several years to bring this about. To reduce disincentives to work, income tax thresholds had been raised, earnings-related supplements to unemployment compensation had been abolished, and unemployment benefits had been made subject to tax. Legislation had been enacted to redress the imbalance in favor of trade unions in labor law. Initiatives had been taken to improve the employability of youth. More recently the national insurance surcharge was abolished, and initial capital allowances are to be phased out, to reduce the bias against labor in investment decisions.

The U.K. representatives were well aware that the impact of these measures would take time to work through to behavior in labor markets. Some progress had already been achieved, such as the increased employment of youth following on a substantial decline in their pay rates relative to those for adults, and also the growth in female employment notably in part-time jobs where pay scales and benefits were more flexible than in regular employment. Nevertheless, there continued to be severe limitations on the scope for the unemployed to price themselves back into the market. Aside from barriers erected by trade unions, and wage councils that set minimum wages for generally nonskilled, nonunionized workers, the mismatch of skills continued to be an important factor maintaining a high degree of market segmentation.

Thus, while expressing confidence that the effects of measures already taken would become increasingly significant in the period ahead, the U.K. representatives felt that much also remained to be done.

6. Trade policy issues

In the United Kingdom, as in other industrialized countries, protectionist pressures have intensified in the past few years against the background of rising unemployment, the worldwide stagnation and the decline in the growth of international trade that has accompanied it, and actions taken by partner countries. The incidence of nontariff barriers has increased significantly on the import side and incentive policies have become more aggressive on the export side, particularly as regards exports of certain agricultural products. One of the features of the recent developments has been the increase in voluntary export restraint measures affecting products other than textiles, clothing, and steel. The most significant of these measures have been those limiting exports from Japan of such products as automobiles and color TV sets.

In reviewing developments in trade policy, the U.K. representatives said that a significant step forward had been taken in 1984 in promoting reforms of the Common Agricultural Policy of the European Communities. In other areas, however, a great deal of effort was expended simply to prevent matters sliding backward in the face of an intensification of protectionist sentiment worldwide. From that perspective, the United Kingdom's performance, which in the area of trade policy should be viewed in the wider context of the common commercial policy of the EC, was not bad. The most positive feature was the agreement, in the context of the roll-back exercise of the OECD, to accelerate tariff reductions scheduled for 1986 under the Tokyo Round, on the conditions that the growth in world trade in 1984 was more than 2 percent and that all the partner countries do likewise. Thus far it had not been possible to put the agreement fully into effect as the U.S. Government had not been able to obtain congressional approval. The United Kingdom, as well as the other members of the EC, would implement some of the tariff reductions at the beginning of 1985, and continued to stand ready to implement the remaining items as agreed.

Looking ahead, the U.K. representatives said that they would continue to pursue the roll-back exercise of the OECD and would also try to find the basis for a new round of multilateral negotiations to further liberalize the international trade system. Multilateral negotiations were the best approach to addressing deficiencies in the international trade system, although under the present climate of strong protectionist sentiment such negotiations might prove to be very difficult to pursue. The

U.K. Government considered the liberalization of trade in services and the questions related to dispute settlements as the most pressing issues in the next round of multilateral negotiations. To be sure, the concentration on services would make it difficult to carry out these negotiations under the auspices of the GATT because at present the GATT did not cover trade in services, but the U.K. Government would make every effort toward achieving a reasonable solution. In referring to the concern of developing countries that their services industries might be wiped out if confronted with the discipline of international competition, the U.K. representatives stressed that it was imperative that these countries made some concession in this area in order to facilitate the efforts of industrialized countries to dismantle remaining barriers affecting LDC exports of goods.

In discussing the possible effects of trade restraints on wage-price inflation, the U.K. representatives noted first that the U.K. economy was very much an open economy with restrictions being an exception. Seen against this background, the rigidities created by trade barriers were judged as much less significant than other elements of rigidities, particularly those in the labor market. Nevertheless, the effects of trade restraints, especially of nontariff barriers, were by no means insignificant, and it was therefore unfortunate that the first phase of the rollback exercise of the OECD did not make any inroads in addressing this issue.

The U.K. representatives observed that much progress had been made in promoting adjustment in industries accorded protection from international competition. In the steel industry, substantial cuts in employment had resulted in a marked improvement in efficiency. Under the EC program for the steel industry, state aid would be phased out by the end of 1985, but pleas for the extension of such aid had increased recently. The U.K. representatives thought that it would not be meaningful to allow the industry to be injured by a flood of imports just at the time when its efforts to adjust started having results. Cuts in employment had also been steep in the textiles and clothing industry, and certain subsectors had been eliminated altogether. While the MFA had certainly slowed the pace at which job losses occurred, it had contributed to making the process of adjustment politically palatable. The industry had begun to lobby for a continuation and increase of the protection it received under the MFA which was to expire in 1986. The Government had no firm view on what measure of protection might be justified in future but, to assist it in its deliberation, it had commissioned an independent study on the effects of the MFA on the U.K. economy.

As regards the automobile sector, the U.K. representatives drew attention to the recent agreement between the EFTA and the EC which had made trade in automobiles between the members of these two areas completely free. The only remaining restriction was with Japan. While emphasizing that protection accorded to this sector was not large, and that the rationalization that had been achieved by the U.K. car industry had been substantial, the U.K. representatives expressed concern about the practices of distributors that helped to keep prices of cars imported from the other EC countries artificially high. They noted that the European Council had made proposals with a view to reducing substantially the artificial price differentials of cars between the EC members.

IV. The Economic Outlook

The official forecast for 1985 made public in November 1984 assumes the nominal exchange rate in 1985 to remain constant at the level of mid-November, and financial policies to be in line with the MTFS projection announced in March 1984. Specifically, the latter means that the growth range for the monetary aggregates in 1985/86 would be 5-9 percent for £M3 (6-10 percent in 1984/85) and 3-7 percent for Mo (4-8 percent in 1984/85), and that the PSBR would be reduced to the equivalent of 2 percent of GDP from an estimated 2 1/2 percent of GDP in 1984/85. The projections made by the staff, in the context of the current World Economic Outlook exercise, are broadly similar to the official forecast and are based on similar assumptions though with a slightly depreciated exchange rate (Table 4).

Although the recovery appears likely to continue, the underlying rate of growth of the economy is projected to decline from 3 percent in 1984 to 2 1/2 percent in 1985. The actual growth in 1984 is estimated to have been reduced to about 2 percent mainly because of the coal miners' strike. If there is an early ending of the strike in 1985, the growth rate in 1985 would rise to over 3 percent. The acceleration reflects the increase in the growth of total domestic demand; net foreign demand is expected to provide very little, if any, contribution to growth in 1985.

After a 2 percent increase in 1984, private consumption is projected to rise by more than 3 percent in 1985, providing the major impetus to the growth in output. Consumer spending would benefit from a sharp recovery in the growth of real personal disposable income, reflecting sizable increases in real average earnings (assuming early ending of the strike) and a further increase in employment. In addition, disposable income would be boosted further by the fiscal adjustment of £1.5 billion now envisaged for the 1985/86 Budget, which is conventionally assumed to take the form of income tax reductions. With income likely to increase strongly, it is plausible to expect the personal saving ratio to rise in 1985.

Total gross fixed investment in 1985 is expected to grow less rapidly than in 1984, with private nonresidential investment remaining the most buoyant component. After providing the main stimulus to growth in 1983, government spending rose more moderately in 1984 and, given the tighter control on public expenditure now envisaged, is expected to contribute to growth only marginally in 1985.

With the growth of domestic demand expected to accelerate in 1985, imports are projected to continue to increase strongly, though at a somewhat slower rate than in 1984, partly reflecting the decline in imports of fuels following the assumed early resolution of the miners' strike.

The authorities expect net foreign demand to make a small positive contribution to growth in 1985 despite a projected deceleration in the growth of exports of goods and services which would reflect the assumed slower growth of demand in the United States, partly offset by somewhat faster growth in Europe. Although in the staff forecast exports would grow faster than assumed by the authorities, the growth in imports would also be higher, with net foreign demand subtracting a small amount from output growth in 1985.

On the assumption of a constant nominal effective exchange rate, the authorities expect the year-on-year rate of inflation, as measured in consumer prices, to come down from 4 3/4 percent in the fourth quarter of 1984 to 4 1/2 percent in the fourth quarter of 1985. However, the deceleration is expected to be brought about by a moderation in the rate of increase in housing costs while the other components of the retail price index, i.e., those least affected by special factors and hence those most indicative of the forces impinging on underlying rates of inflation, would probably show some acceleration in 1985. With average earnings in manufacturing still increasing at a rate of nearly 9 percent, unit wage costs would probably continue to rise strongly while import price increases should accelerate despite the weakness in commodity prices. On balance, with the current stance of financial policies, price inflation could rise to above 5 percent in 1985.

Even with the projected 3 percent growth for real GDP, the unemployment situation is not likely to improve in 1985. Total employment could grow further by about 1 percent in 1985, but the increase is expected to continue to be concentrated in part-time jobs for women. This, as well as demographic patterns, would tend to boost the growth in the labor force. As a result, the number of unemployed is unlikely to show any significant decline and could well rise further, in view especially of the continuing rapid growth in wage earnings.

After recording a surplus of £2.0 billion (0.7 percent of GDP) in 1983, the current account of the balance of payments is estimated to have been broadly in balance in 1984. In 1985, the current account is projected to return to a small surplus, as the continued deterioration in the non-oil trade balance is more than offset by improvements in the oil balance and invisibles. The growth in non-oil export volume is likely to decelerate mainly in response to slower growth in export markets, while non-oil import volume is expected to continue to grow strongly. The authorities project a small decline in the United Kingdom's share of the domestic and foreign markets of manufactured goods, with improved competitiveness partly offsetting a larger trend decline in market share. The volume of oil exports is expected to grow slowly in 1985, while oil import volume would decline if there is an early ending of the miners' strike. A larger surplus on invisibles is expected in 1985, mainly reflecting the improvement in the balance on interest, profits, and dividends.

V. Staff Appraisal

The United Kingdom has been a pioneer in the pursuit of policies that have become an international norm: there is now a broad consensus among the major countries that the control of inflation will contribute to sustained economic growth in the medium term. It is also generally accepted that monetary and fiscal restraint are essential if inflation is to come down. The experience with such policies in the United Kingdom is therefore of keen interest to the international community.

The authorities have had considerable success with their financial strategy, but this success has not been achieved without stress. The growth in nominal GDP has been lowered progressively from over 15 percent in 1979-80 to less than 7 percent by the first three quarters of 1984, and the split between price inflation and output gains has lately become more satisfactory. Price inflation has been brought down below 5 percent, and the growth of output has averaged close to 3 percent over 1983-84, despite the disruptions caused by the prolonged miners' strike. However, wage inflation has remained stubbornly high, and the external position has again come under pressure. The rate of unemployment has continued to increase and now stands at some 13 percent.

With inflation down to a moderate level but unemployment still rising, the authorities have found it increasingly difficult to resist pressure for a relaxation of their counterinflationary policy stance. Although this is understandable, there are greater risks in tilting policies toward expansion than in maintaining a steady stance against inflation. This is the case even though any tilting would be taking place within the scope of a broadly unchanged medium-term strategy. There is surely some lack of ambition in a policy stance this year and next, that promises no better than to leave inflation unchanged at just under 5 percent.

The expansion of the targeted monetary aggregates thus far in 1984/85 has remained close to, if not within, the target ranges set for them at the beginning of the financial year. However, these target ranges have proved consistent with developments in domestic interest rates relative to those abroad, that have contributed to a fall in the nominal effective exchange rate by as much as 10 percent in the 12 months to December 1984. Other aggregates have in any case been expanding much more rapidly. There has been need on occasion, particularly in July 1984 and again in January 1985, to adjust interest rates upward to minimize the inflationary threat from a depreciating exchange rate. There clearly is a limit to the extent to which the United Kingdom can decouple its real interest rates from those in the United States in current conditions of fairly mobile capital. To the extent it cannot, monetary expansion will only depress the exchange rate and drive up prices.

Though the main monetary targets may still be met this year, the PSBR is all but certain to exceed the level specified for it in the budget. The whole of the excess is due to spending overruns inasmuch as revenues are also higher than anticipated. The stimulatory effect has been considerable, while the adverse effects on real interest rates have been small, linked as domestic rates are to those abroad. The urgency of bringing down the borrowing requirement may have become less on this account. Actual reductions have already placed increasing reliance on oil revenue and on asset sales, neither of which have a major impact on demand or on monetary conditions. Excluding these items shows the PSBR rising in relation to GDP, not only above the level budgeted for it this year, but above the level registered the year before.

If monetary conditions were tight, such developments might not appear overly disquieting, in the immediate present. Even then they would store up dangers for the future. The danger of particular concern internationally is the demonstration effect on other countries which, like the United Kingdom, may not individually have a significant effect on world interest rates but collectively certainly do. With all countries acting together, there might not be significantly adverse balance of payments effects. Acquiescence would, however, run the risk of rekindling inflationary expectations. It would also delay the time when the growth of public debt in the United Kingdom can be scaled down to leave adequate room for private debt to expand in a framework of noninflationary growth.

Monetary ease sufficient to place downward pressure on exchange rates may be considered defensible only if it succeeds in improving competitiveness without interrupting the progress in reducing inflation. Improvements in competitiveness did occur after 1981 because extensive labor shedding raised productivity fast enough to absorb wage increases. However, such productivity increases dropped sharply in 1984 and, as wages continued to rise, unit wage costs accelerated markedly to a rate well above the current rate of price inflation. In the absence of adequate wage moderation, therefore, it will clearly not be possible to improve competitiveness by exchange depreciation, or to support a monetary policy that fails to restrain it.

The troublesome increases in wages may in large part reflect a lag in the downward adjustment of the still high inflationary expectations behind the fall in actual inflation. Wage contracts apparently set nominal wages that, given price expectations, should produce a real wage that will maintain employment. If actual prices turn out to be higher, real wages will be lower and employment temporarily higher than anticipated; if actual prices are lower, real wages will rise and employment be reduced. A policy of continued financial restraint may well offer the best prospect to narrowing the expectations gap, and so to arrest the tendency for unemployment to rise.

If unemployment is actually to be brought down, however, such a policy needs to be supplemented by measures that will directly improve the functioning of labor markets. In finding the market clearing wage, the effective supply seems often to be limited to those workers still employed. In such cases there is little scope for the real wage once set to be reduced and no direct way, therefore, to re-employ any workers once out. There is need to reduce the barriers to entry not only for new entrants into the labor force, but for anyone seeking a job.

The functioning of labor markets has already improved in a number of ways in recent years. Thus the pay of young workers, relative to that of adults, seems to have been falling for some time now, suggesting that their share in total employment may now begin to increase. Similarly, the growth in employment in recent years seems to be accounted for entirely by women in part-time work where wage costs are not inflated by government or trade union policy. Much more needs to be done before such impediments to employment are reduced for adult full-time workers as well.

The U.K. authorities have played a useful role in promoting reforms in the Common Agricultural Policy of the EC. While these reforms are welcome, they are not adequate to solve the problem of overproduction afflicting many agricultural products. It is therefore to be hoped that the United Kingdom will continue to press for the additional necessary reforms of CAP. The United Kingdom may also be expected to play a leading role in rolling back formal and informal barriers affecting imports of manufactures from both industrial and less developed countries.

It is recommended that the next consultation with the United Kingdom be held according to the standard 12-month cycle.

Table 1. United Kingdom: Public Sector Funding and Acquisition of Commercial Bills by the Bank of England

(In billions of pounds)

		Overfunding 1/	Net Acquisition of Commercial Bills by the Issue Department of the Bank of England 2/
1978/79		-0.7	-0.1
1979/80		-0.8	0.8
1980/81		-2.4	2.0
1981/82		2.5	4.2
1982/83		-0.7	-0.8
1983/84		2.4	3.6
1984/85	April	-2.4)	
	May	-0.1)	-2.6
	June	-1.2)	
	July	1.1)	
	August	0.3)	2.0
	September	-0.5)	
	October	1.1)	
	November	-0.9)	0.6 3/
	December	-0.3)	
Nine-month total		-2.2	--

Source: Bank of England, Quarterly Bulletin, December 1984.

1/ Purchases of public sector debt by U.K. nonbank private sector minus PSBR; for 1984/85 PSBR excludes changes in public sector deposits. Plus implies overfunding.
2/ Excludes acquisition of commercial bills by the Banking Department.
3/ Includes Issue Department's net acquisitions of all non-government securities.

Table 2. United Kingdom: PSBR, Actual and Adjusted

	1979/80	1980/81	1981/82	1982/83	1983/84	1984/85 1/	1985/86 2/
				(In billions of pounds sterling)			
PSBR, actual	10.0	12.6	8.6	8.9	9.7	8.4	7.0
Plus oil revenues	+2.4	+3.8	+6.4	+7.8	+8.9	+12.0	+12.0
Less permanent income from oil	-1.6	-1.9	-2.1	-2.2	-2.3	-2.4	-2.5
Plus special asset sales	+1.0	+0.4	-0.1	+0.5	+1.1	+2.3	+2.5
PSBR, adjusted	11.8	14.9	12.8	15.0	17.4	20.3	19.0
				(In percent of GDP)			
PSBR, actual	4.8	5.3	3.3	3.1	3.2	2.6	2.0
PSBR, adjusted	5.7	6.3	4.9	5.3	5.7	6.2	5.4

Source: Data provided by the U.K. authorities.

1/ Revised estimates.
2/ Projections.

Table 3. United Kingdom: Inflation, Inflationary Expectations, and Real Wage Increases

	1981	1982	1983	1984
Actual inflation 1/	11.9	8.6	4.6	5.0
Expected inflation 2/	12.6	9.9	8.0	7.4
Nominal wage increase: 3/				
Whole economy	12.9	9.4	8.4	6.0
Manufacturing	13.3	11.2	9.0	8.8
Actual real wage increase: 4/				
Whole economy	1.0	0.8	3.8	1.0
Manufacturing	1.4	2.6	4.4	3.8
Expected real wage increase: 5/				
Whole economy	0.3	-0.5	0.4	-1.4
Manufacturing	0.7	1.3	1.0	1.4

Source: CSO, Economic Trends and Financial Statistics.

1/ Percentage change in the retail price index from preceding period.
2/ Yield differential between nonindexed and indexed government securities.
3/ Percentage change in average earnings from preceding period.
4/ Nominal wage increase less actual inflation.
5/ Nominal wage increase less expected inflation.

Table 4. United Kingdom: Projections of Selected Indicators

	1984	1985	1984	1985
	Official projections		Staff projections	
	(Percentage changes from preceding year, except as indicated)			
Aggregate demand 1/				
GDP 2/	2.2	3.5	2.0	3.0
Total domestic demand	2.5	3.4	2.6	3.1
Private consumption	2.1	3.3	1.9	3.1
Government consumption	1.8	1.0	0.7	0.8
Gross fixed investment	7.8	3.1	7.6	3.5
Stockbuilding 3/4/	-0.5	0.8	-0.1	0.4
Net foreign demand 3/	-0.4	0.1	-0.6	-0.1
Exports	5.8	4.3	5.8	4.8
Imports	7.7	4.0	8.3	5.1
Output, employment, and costs				
Industrial production	...	...	-0.2	3.1
Unemployment rate 5/	...	...	12.7	12.9
Unit labor cost 6/	...	...	4.5	4.5
Prices				
GDP deflator	4 3/4 7/	4 1/2 7/	4.5	5.0
Consumer Price Index	4 3/4 8/	4 1/2 8/	5.0	5.1
	(In billions of pounds)			
Balance of payments				
Trade balance	...	...	-4.1	-4.9
Of which: Non-oil	...	...	-11.4	-13.5
Services and transfers	...	...	4.3	6.1
Current balance 9/	--	2 1/2	0.2	1.2

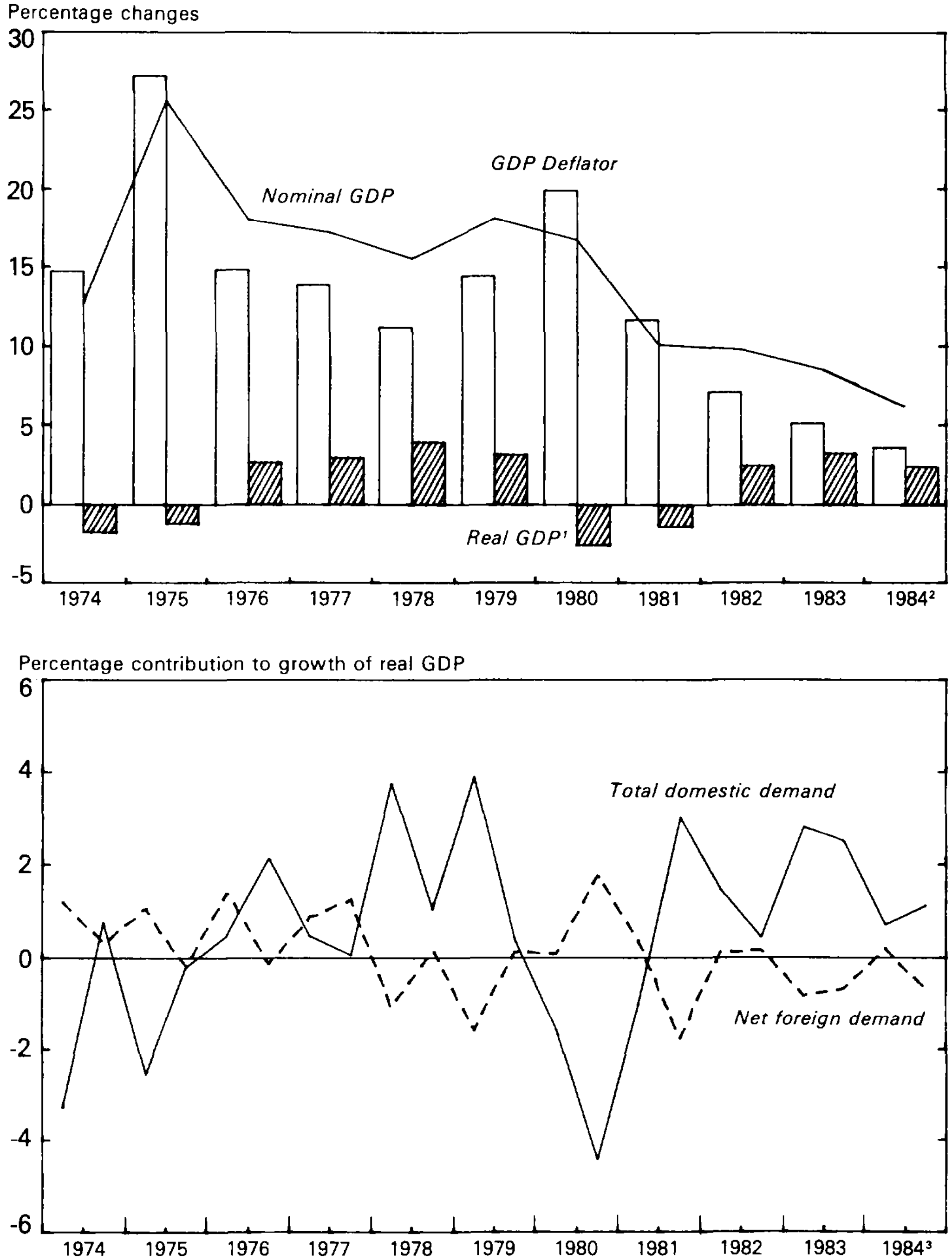
Sources: HMSO, Autumn Statement, 1984; and staff estimates.

1/ Constant prices, 1980 base.
2/ Average estimate, at market prices.
3/ Contribution to real GDP growth.
4/ Includes the compromise adjustment to GDP.
5/ In percent of total employees.
6/ Manufacturing sector.
7/ Fiscal years.
8/ Fourth quarter over fourth quarter of preceding year.
9/ Including official transfers.

CHART 1

UNITED KINGDOM

REAL GDP GROWTH



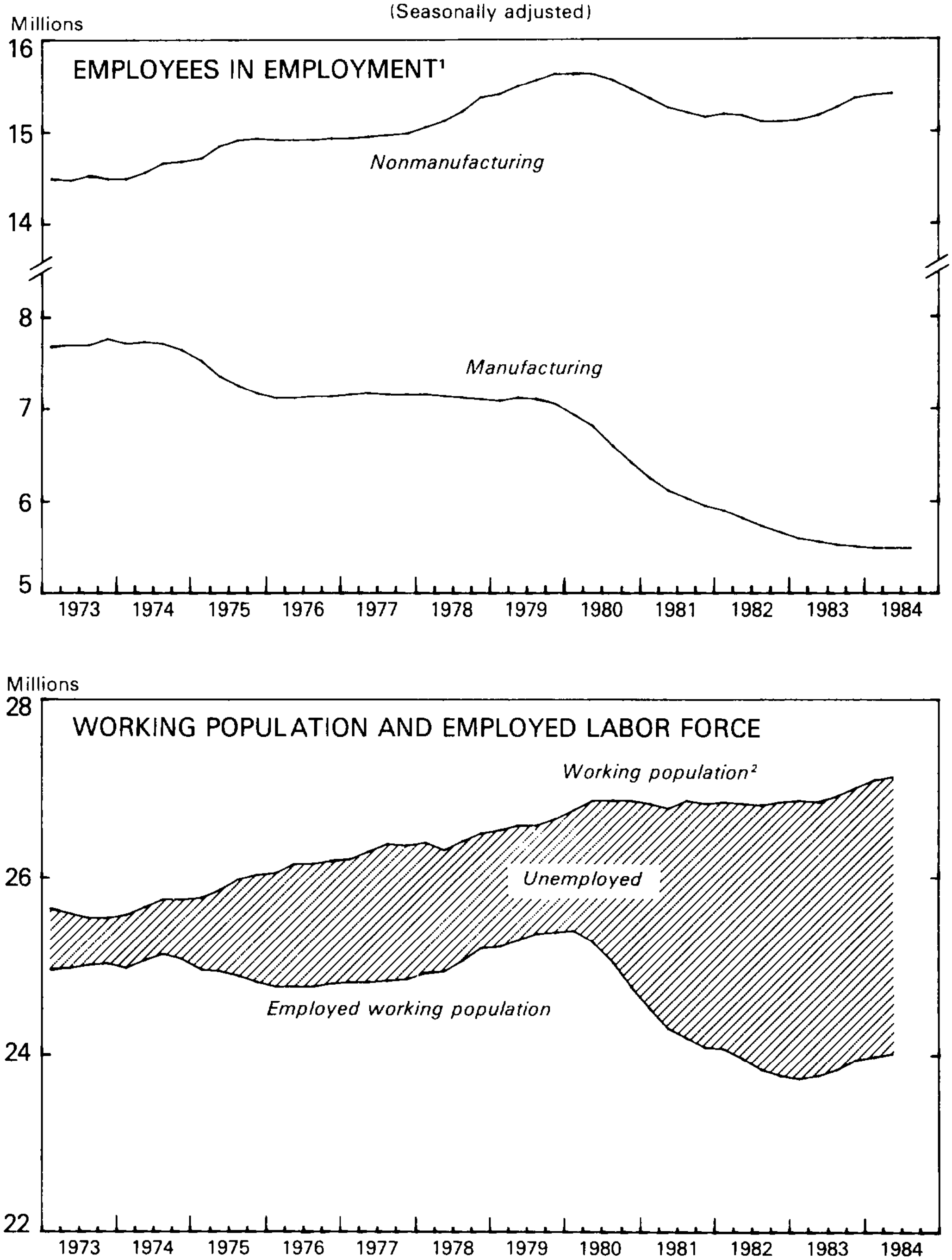
Sources: CSO, *Economic Trends*, and staff estimates.
[1] In 1980 prices
[2] First three quarters of 1984 over the corresponding period of 1983.
[3] Percentage contributions to growth in the second half are staff estimates.

CHART 2

UNITED KINGDOM

EMPLOYMENT, 1973-84

(Seasonally adjusted)



Source: U.K. Department of Employment, *Employment Gazette*.

[1]Data are for Great Britain.

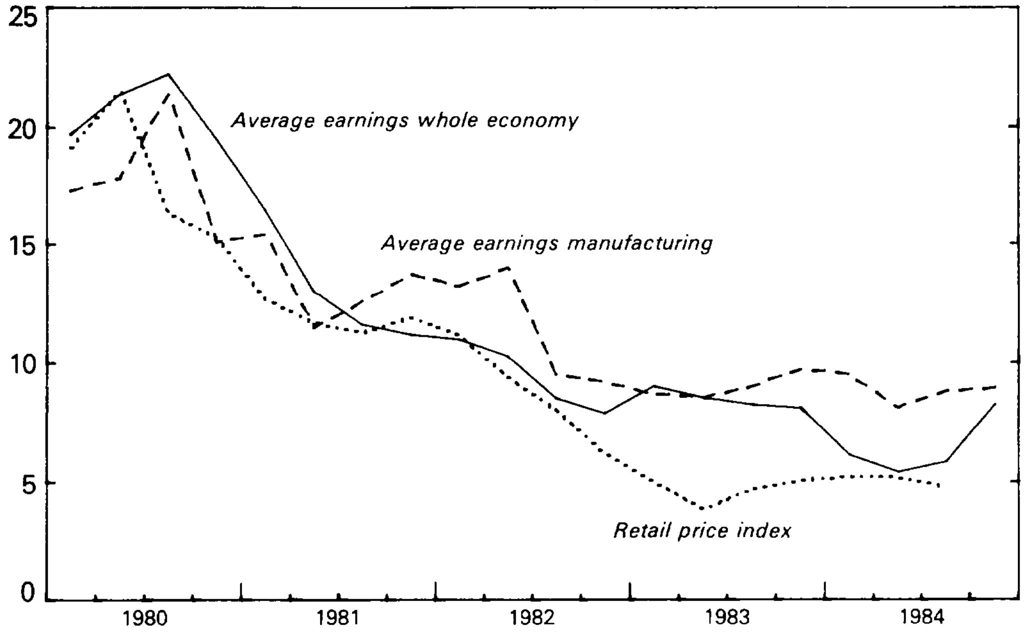
[2]Employed labor force plus the unemployed.

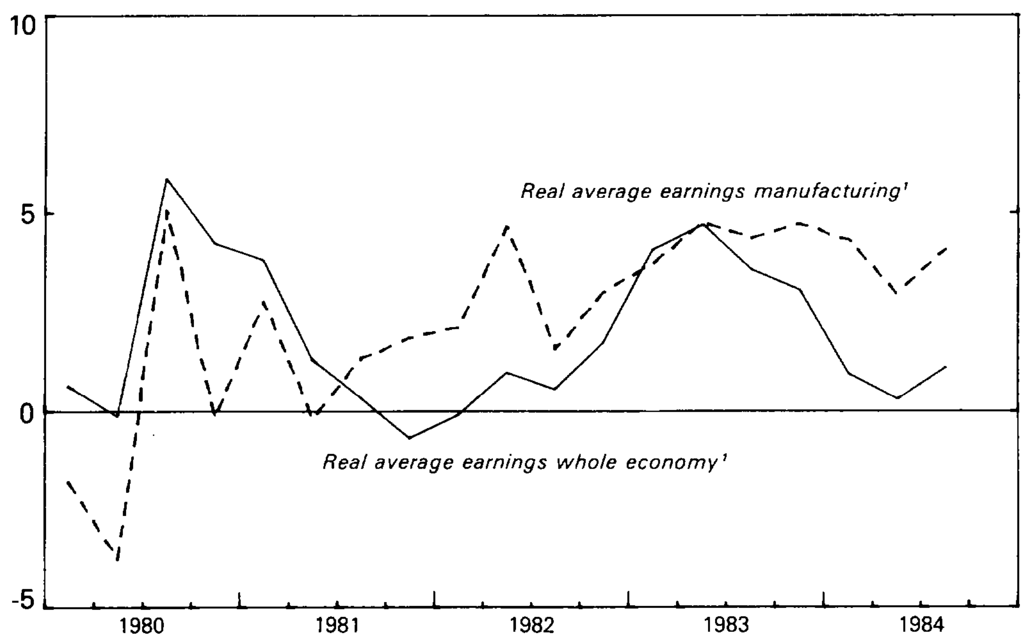
CHART 3

UNITED KINGDOM

PRICES AND EARNINGS

(Year-on-year rate of change, in percent)





Source: CSO, *Economic Trends.*

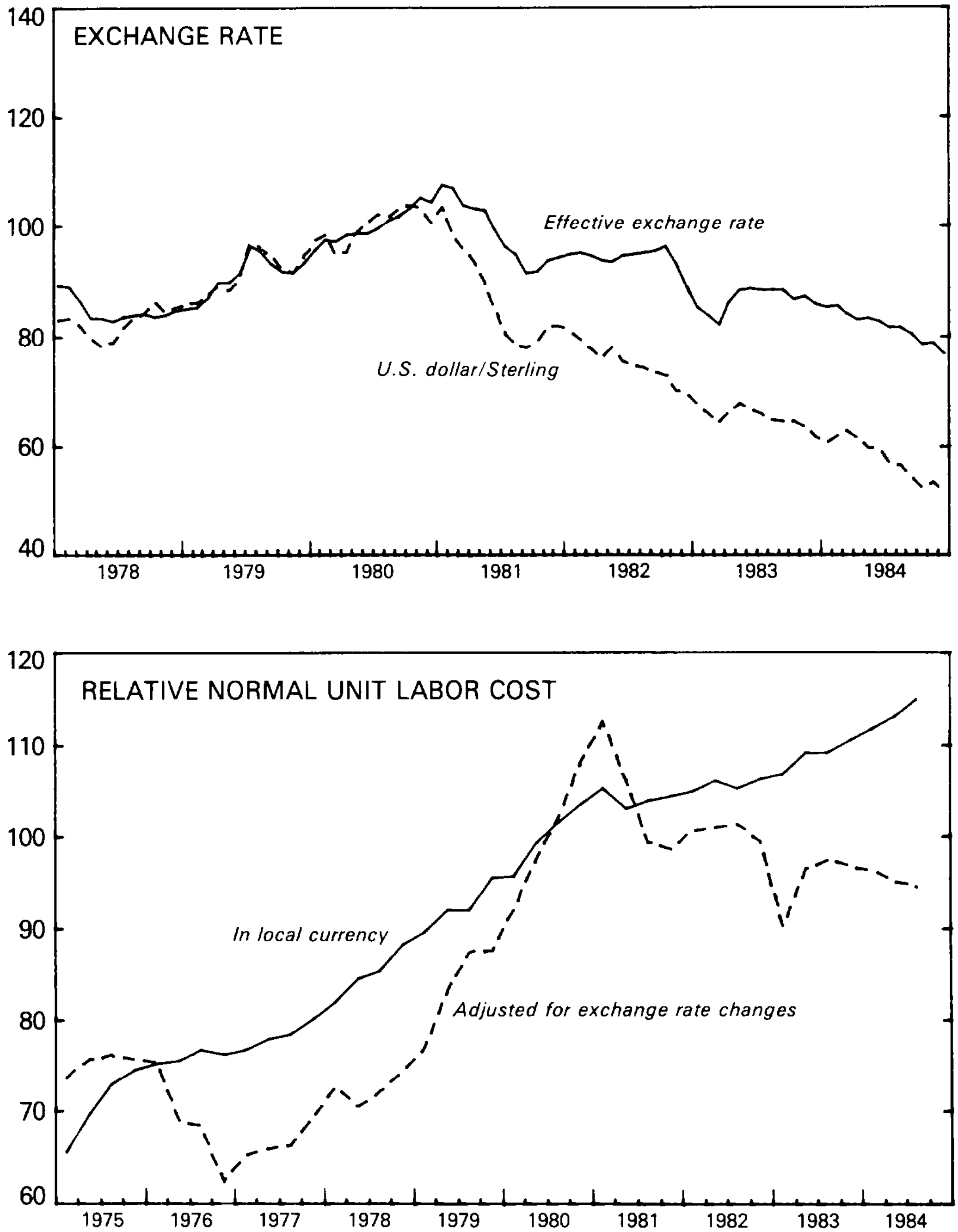
[1] Average earnings deflated by the retail price index.

CHART 4

UNITED KINGDOM

DEVELOPMENTS IN THE EXCHANGE RATE OF STERLING AND IN THE INTERNATIONAL COMPETITIVENESS OF MANUFACTURING, 1975-84

(1980=100)

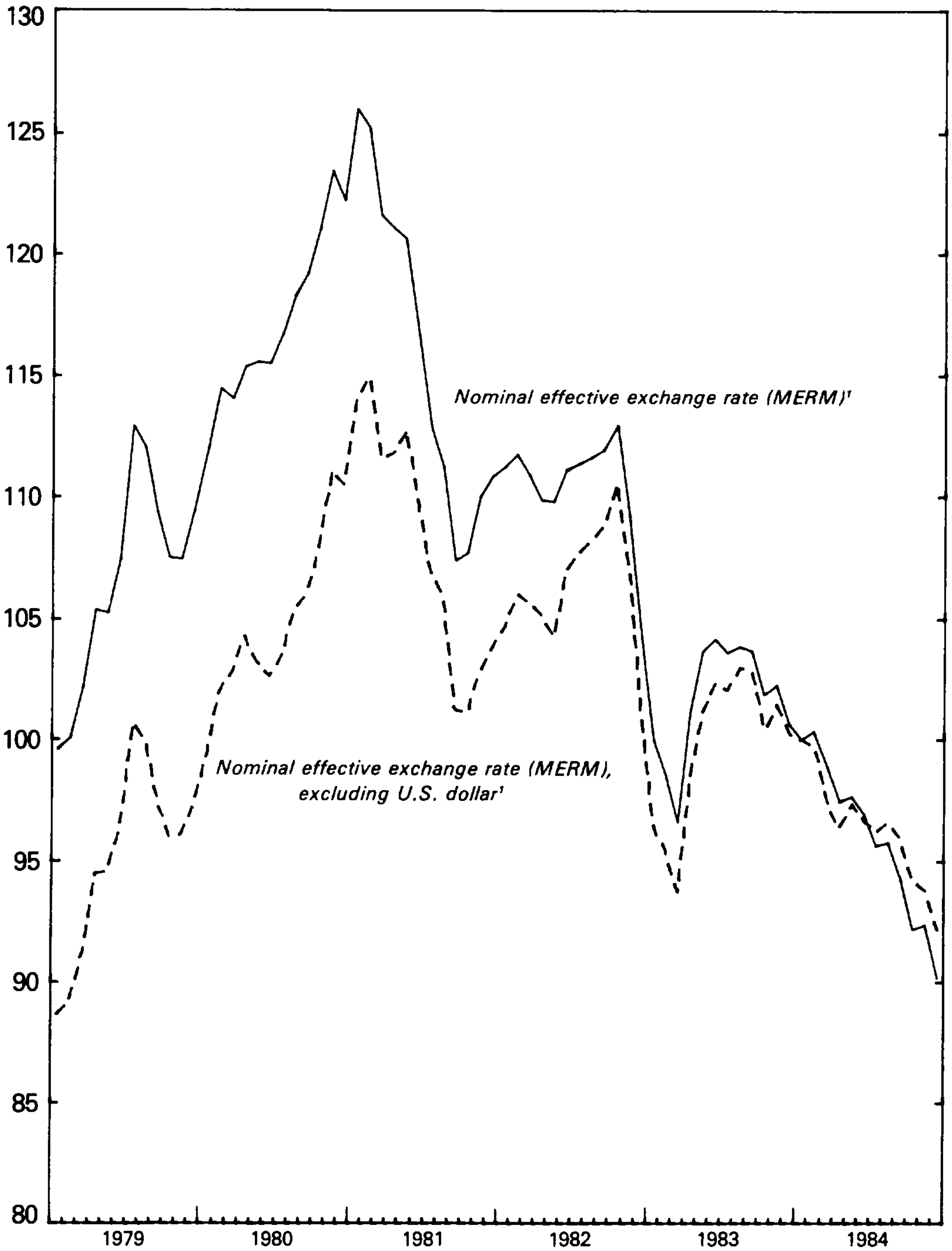


Source: IMF, *International Financial Statistics.*

CHART 5

UNITED KINGDOM

EFFECTIVE EXCHANGE RATES



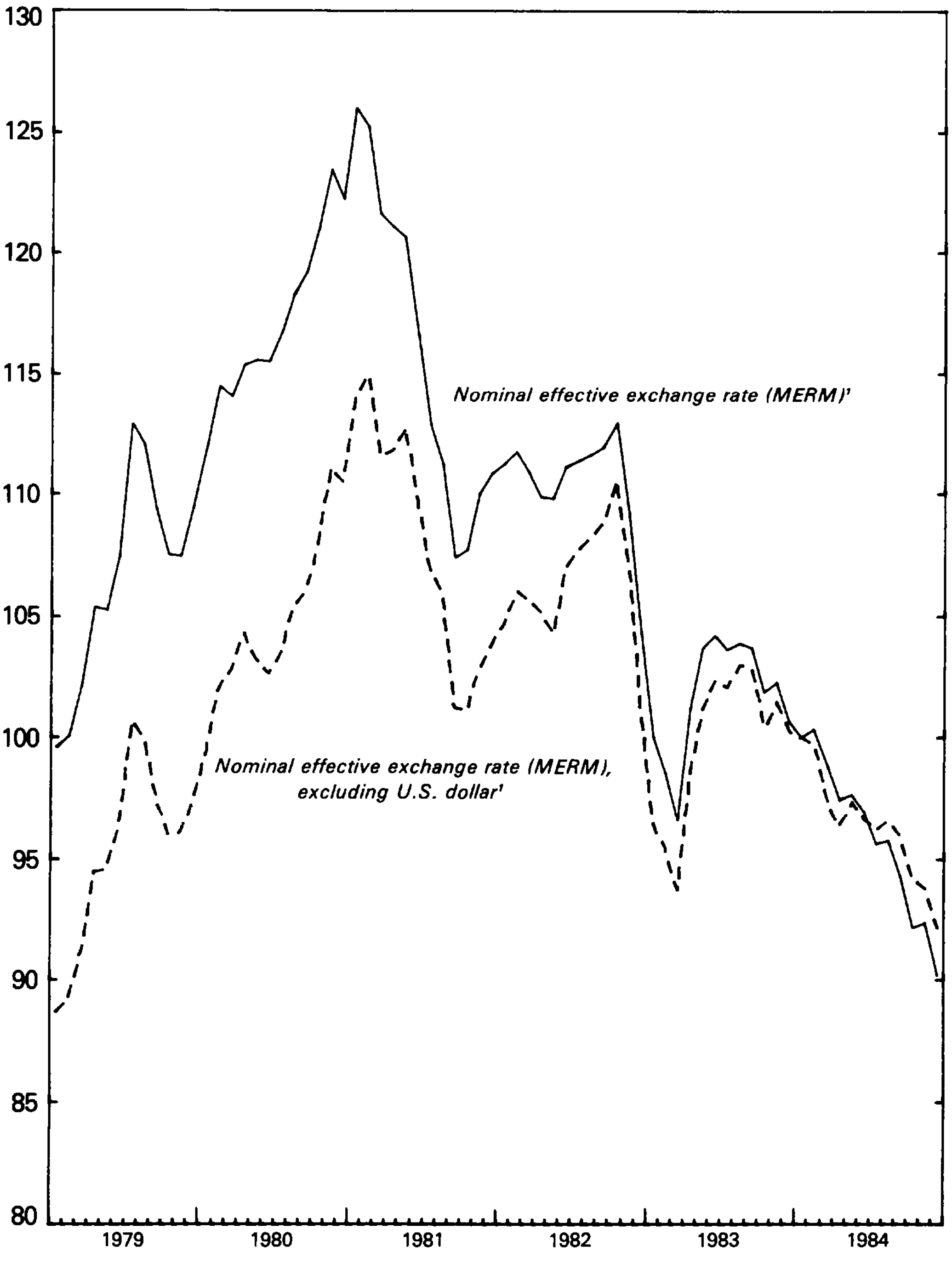
Sources: IMF, *Datafund;* and staff calculations and estimates.

[1]January 1984=100.

CHART 5

UNITED KINGDOM

EFFECTIVE EXCHANGE RATES

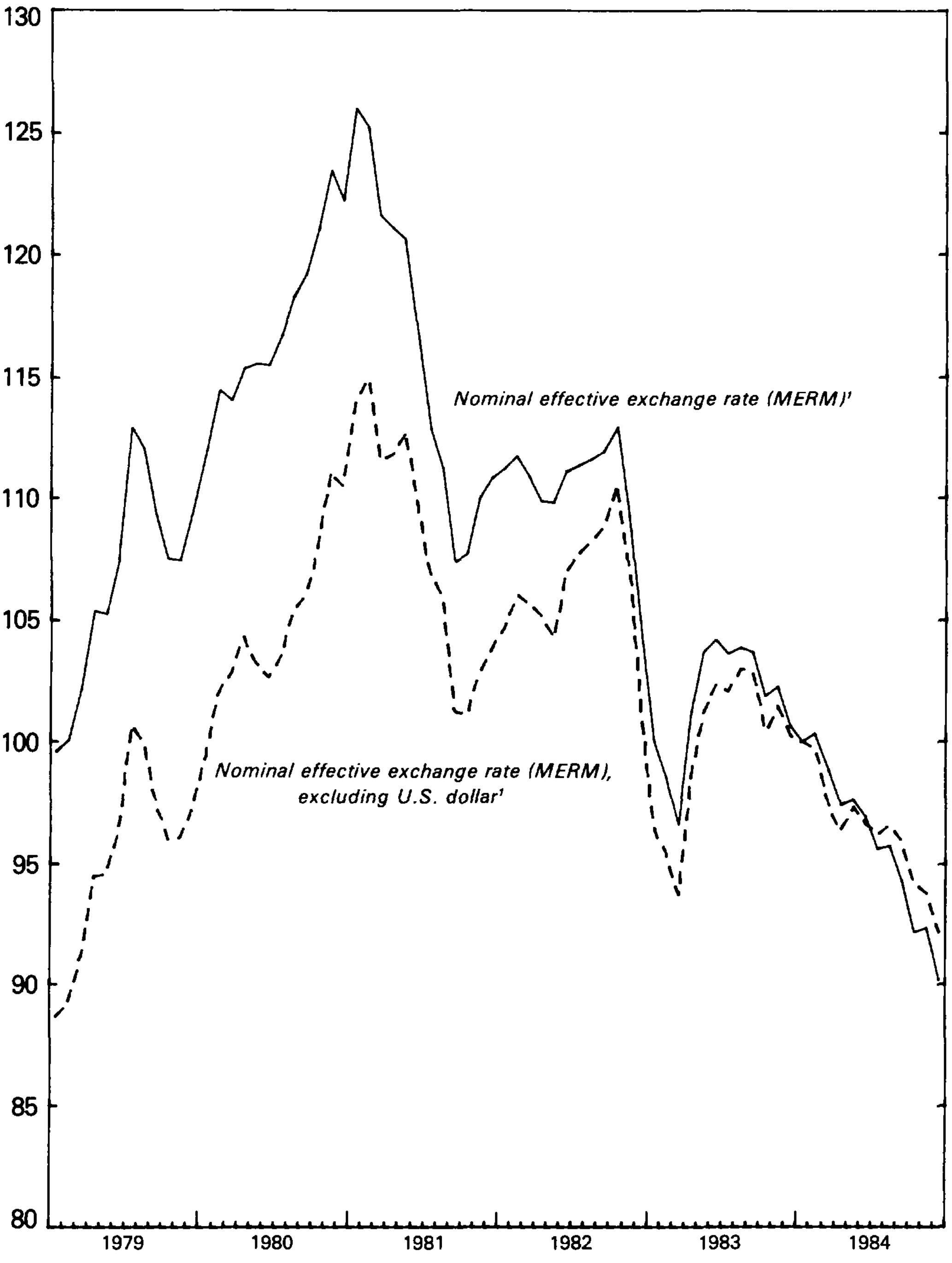


Sources: IMF, *Datafund;* and staff calculations and estimates.
[1]January 1984=100.

CHART 5

UNITED KINGDOM

EFFECTIVE EXCHANGE RATES



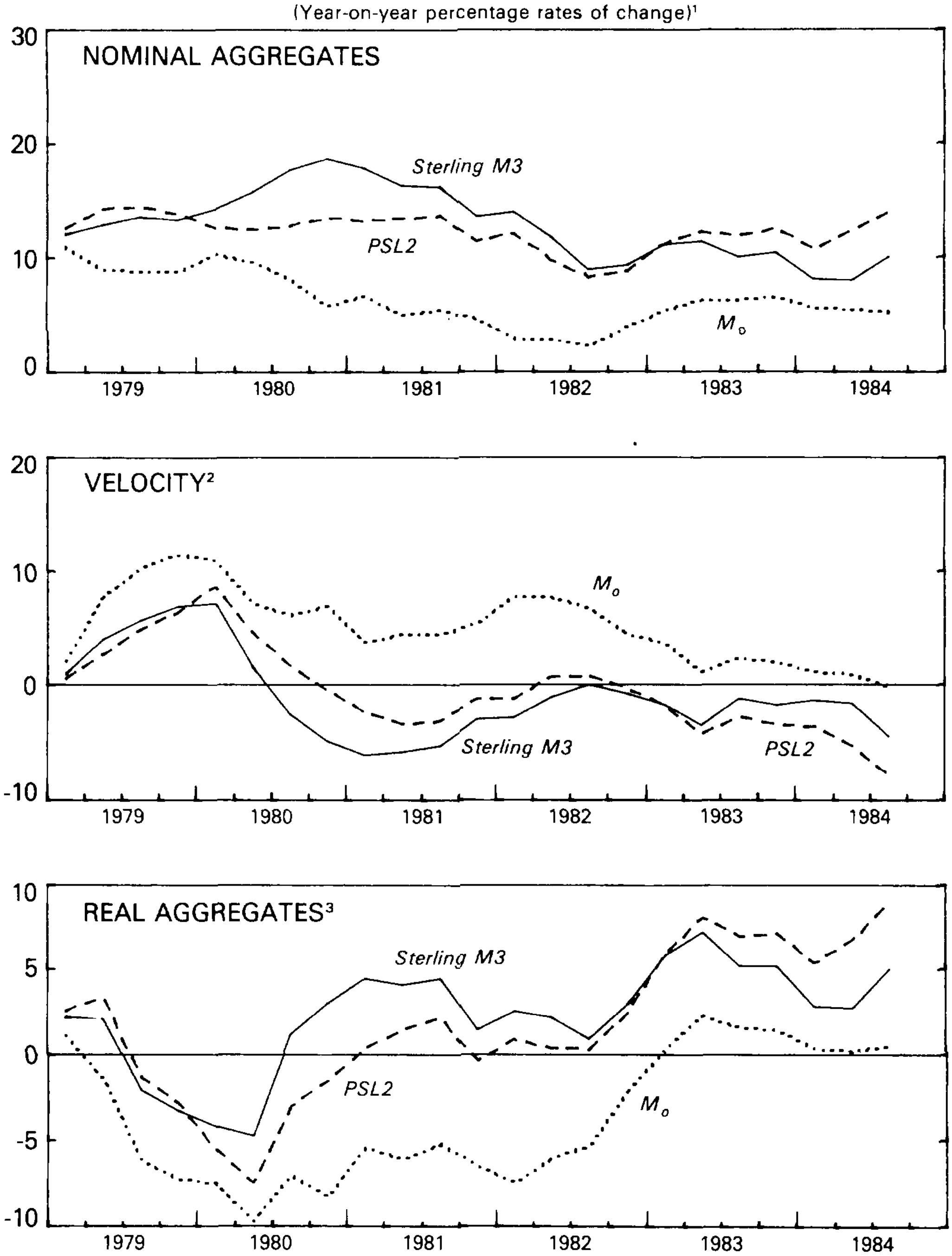
Sources: IMF, *Datafund;* and staff calculations and estimates.
[1]January 1984=100.

CHART 6

UNITED KINGDOM

MONETARY DEVELOPMENTS

(Year-on-year percentage rates of change)[1]



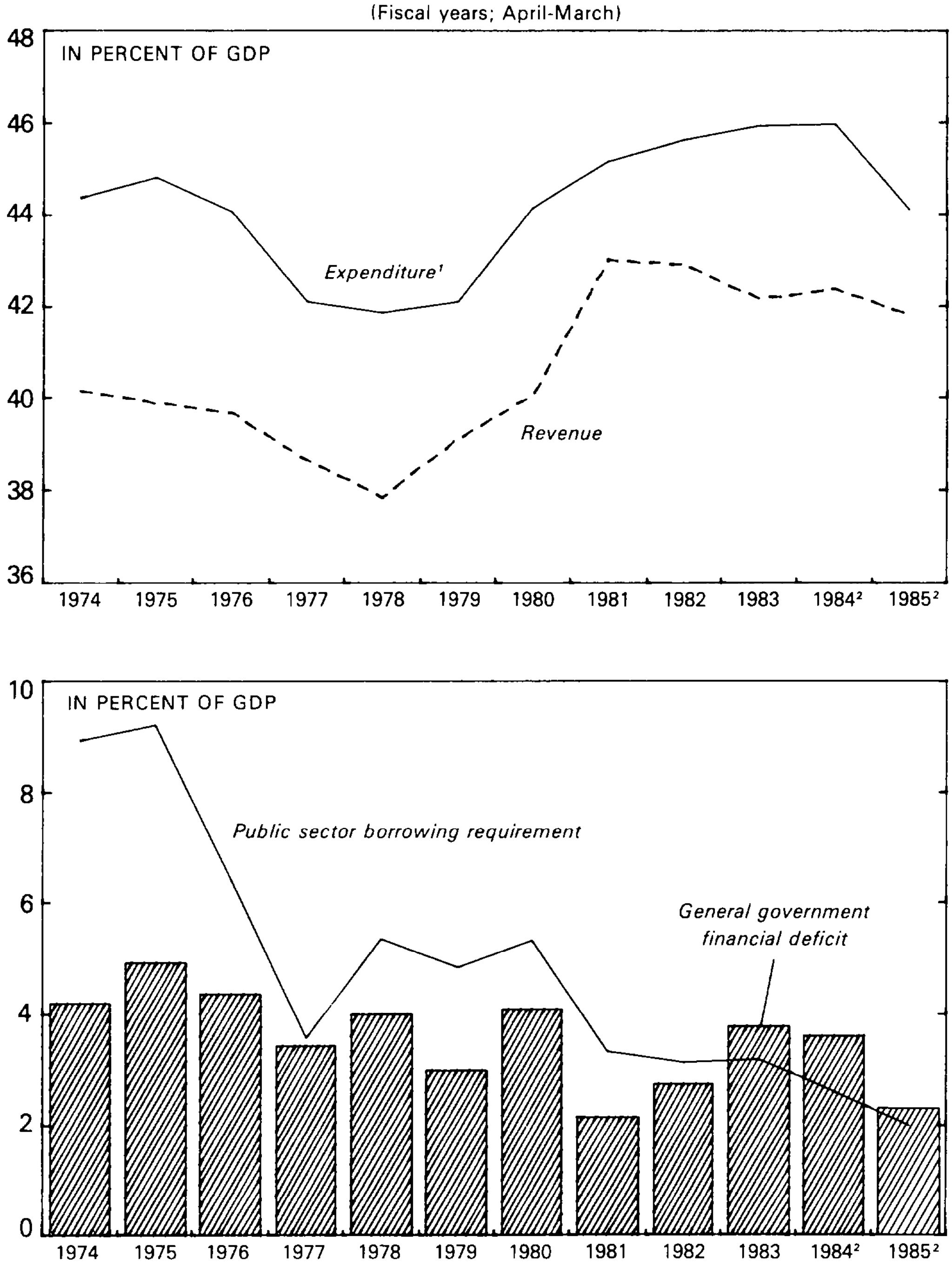
Source: Bank of England. *Quarterly Bulletin*.
[1] Data for period before August 1981 have been adjusted for breaks in series at that date.
[2] Nominal GDP divided by nominal aggregates.
[3] Nominal aggregates deflated by the RPI.

CHART 7

UNITED KINGDOM

GENERAL GOVERNMENT

(Fiscal years; April-March)



Sources: CSO, *Financial Statistics*, and data provided by the U.K. authorities.

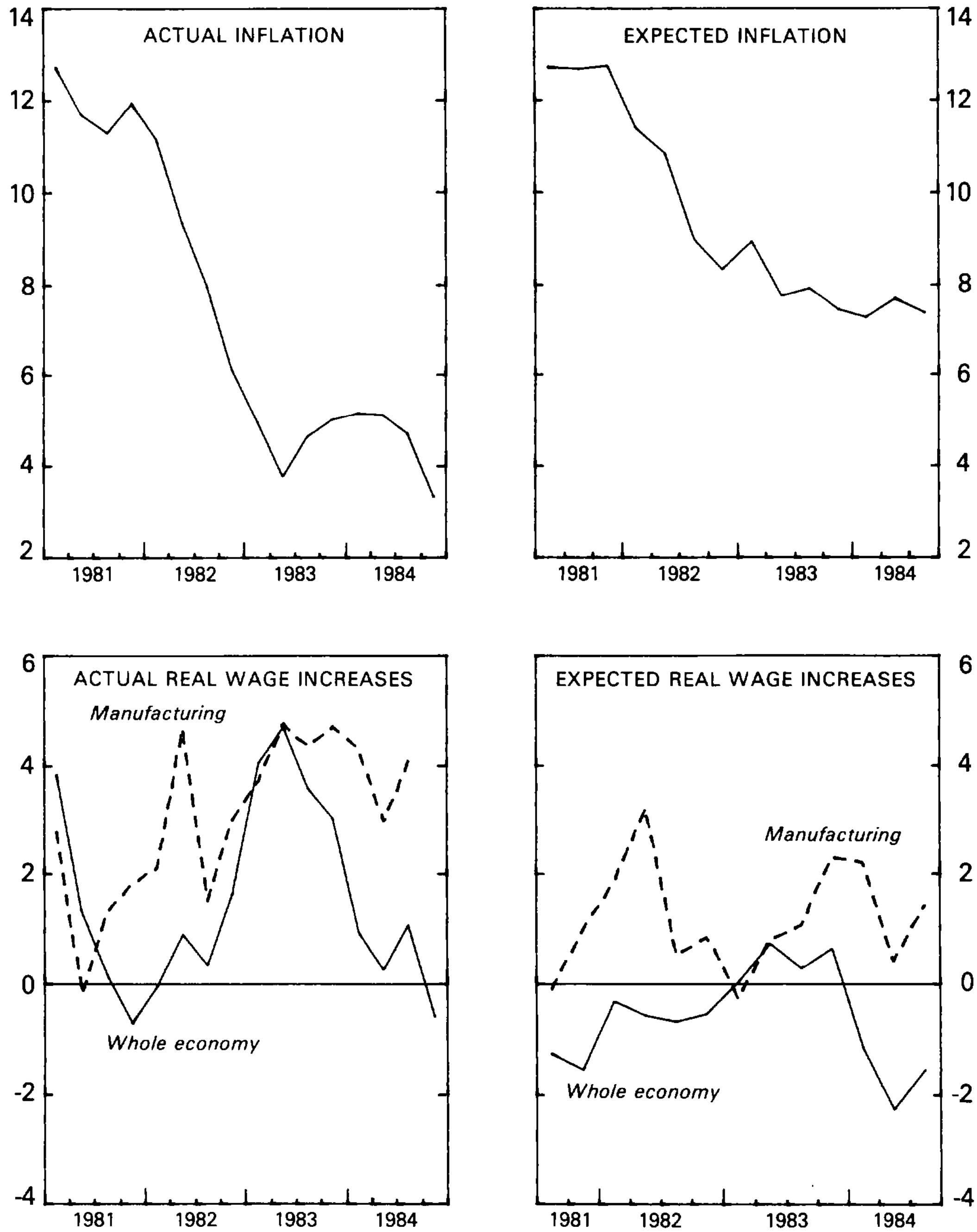
[1] Excludes net lending.

[2] Based on the *Autumn Statement* November 1984.

CHART 8

UNITED KINGDOM

INFLATION, INFLATIONARY EXPECTATIONS AND REAL WAGE INCREASES[1]



[1] For sources and definitions, see Table 3.

United Kingdom - Basic Data

Area and population

Area	94,247 square miles (244,100 square kilometers)
Population (mid-1983)	56,377,000
GDP per capita (1983)	$8,109

Composition of GDP in 1983, at current prices	In billions of pounds	Distribution in per cent
Private consumption	182.4	60.5
Public consumption	65.9	21.9
Total investment (including stockbuilding)	49.8	16.5
Total domestic demand	298.1	98.9
Exports of goods and services	79.8	26.5
Imports of goods and services	-76.6	-25.4
GDP at market prices (expenditure estimate)	301.3	100.0

Selected economic data, annual percentage change (period average)	1982	1983	1984
Real GDP (at market prices, average estimate)	2.4	3.2	2.4 1/
Manufacturing production	0.1	2.5	2.9 1/
Average earnings 2/	11.2	9.0	8.8 1/
Unit wage costs 2/	5.4	2.0	4.2 1/
Retail price index	8.6	4.7	5.0
Rate of unemployment (in percent)	11.5	12.3	12.7
Mo 3/	3.9	6.4	6.6
Sterling M3 3/	9.3	10.5	9.5
PSL2 3/	8.8	12.5	14.5

Public sector accounts, in billions of pounds	1982/83 Outturn	1983/84 Outturn	1984/85 Estimate 4/
General government receipts	121.7	128.8	138.5
General government expenditure 5/	129.5	140.4	150.3
Financial balance	-7.7	-11.5	-11.8
(In percent of GDP)	(-2.7)	(-3.8)	(-3.6)
Public sector borrowing requirement	8.9	9.7	8.5
(In percent of GDP)	(3.1)	(3.2)	(2.6)

Balance of payments, in billions of pounds	1982	1983	1984
Exports	55.6	60.6	70.4
Imports	53.5	61.7	74.6
Trade balance	2.1	-1.1	-4.1
Net invisibles	2.8	3.4	4.3
Current account balance	4.9	2.3	0.2
Investment and other long-term capital	-7.6	-5.5	-8.5 6/
External sterling liabilities	4.3	4.2	5.4 6/
Trade credits and other short-term capital 7/	-3.0	-1.8	2.6 6/
Balance for official financing	-1.4	-0.9	-1.2 6/
Gross reserves, official basis (millions of SDRs) 8/	15.4	17.0	16.0
Gross reserves, IFS basis (millions of SDRs) 8/	11.9	11.5	10.3
Average effective exchange rate index (1980 = 100)	94.2	86.7	81.9

1/ First three quarters of 1984 over the corresponding period of 1983.
2/ Manufacturing sector.
3/ End period; for 1984, mid-December over mid-December.
4/ Revised estimate based on the Autumn Statement (November 1984).
5/ Excluding net lending.
6/ January to September.
7/ Including balancing item and allocation of SDRs.
8/ As of the end of December.

United Kingdom - Fund Relations

(As of December 31, 1984)

I. Membership Status

(a) Date of membership:	December 27, 1945
(b) Status:	Article VIII

(A) Financial Relations

II. General Department

(a) Quota:	SDR 6,194 million
(b) Fund holdings of pound sterling:	SDR 4,182.3 million (67.5 percent of quota)
(c) Fund credit:	None
(d) Reserve tranche position:	SDR 2,011.8 million
(e) Current operational budget:	The pound sterling is included in the current operational budget for maximum sales of SDR 37.6 million.

	Limits	Outstanding	Uncalled
(f) Lending to the Fund: GAB	1,700.0	--	1,700.0

III. Current Stand-By — Not relevant

IV. SDR Department

(a) Net cumulative allocation:	SDR 1,913.1 million
(b) Holdings:	SDR 506.9 million, 26.5 percent of net cumulative allocation
(c) Current designation plan:	Maximum amount of designation is SDR 291.9 million

V. Administered Accounts — *Not applicable*

(B) Nonfinancial Relations

VIII. Exchange Rate Arrangements

The U.K. authorities do not maintain margins in respect of exchange transactions, and exchange rates are determined largely on the basis of demand and supply conditions in the exchange markets. The exchange rate of sterling was £1 = US$1.129 on January 31, 1985. In the course of 1984, the effective exchange rate (MERM) depreciated by 10 1/2 percent.

IX. Last Article IV Consultation

Discussions for the 1983 Article IV consultation were held in London from December 1 to 12, 1983. The staff report for the 1983 Article IV consultation (SM/84/35, 1/31/84) was considered by the Executive Board on February 27, 1984 (EBM/84/31). The United Kingdom is on the 12-month consultation cycle.

United Kingdom - Statistical Issues

1. Coverage, Currentness, and Reporting of Data in IFS

		Latest Data in December 1984 IFS
Real Sector	- National Accounts	Q2 1984
	- Prices	September 1984
	- Production	August 1984
	- Employment	March 1984
Government Finance	- Deficit/Surplus	Q2 1984
	- Financing	Q2 1984
	- Debt	...
Monetary Accounts	- Monetary Authorities	Q2 1984 (partial)
	- Deposit Money Banks	Q2 1984
	- Other Financial Institutions	...
External Sector	- Merchandise Trade: Values	August 1984
	- Merchandise Trade: Prices	August 1984
	- Balance of Payments	Q2 1984
	- International Reserves	October 1984
	- Exchange Rates	October 1984

During the past year, the reporting of data for inclusion in IFS has been excellent.

2. Outstanding Statistical Issues

Money and Banking

Balance sheet data in IFS for the central bank and the deposit money banks are reported on a quarterly, rather than a monthly, frequency. There is no coverage of other financial institutions. The absence of monthly reports reflects a longstanding problem whereby the adoption of the IFS definition of monetary authorities would lead to the disclosure, on a monthly basis, of confidential information on certain central bank transactions. A recent change in the presentation of banking data by the central bank, and a planned shift in the reporting date for deposit banks' data from mid-month to end-month, are expected to resolve these problems. This would enable attention to be given to the development of a separate section in IFS on other financial institutions, and a Financial Survey.

Government Finance

There are gaps in the United Kingdom's presentation in the Government Finance Statistics Yearbook. No data are available for a number of years for the components of domestic and foreign financing, and for the functional analysis of expenditure.